

Case Comment

Reed v. Commissioner: A Case for the Economic Benefit Doctrine

I. INTRODUCTION

In *Reed v. Commissioner*¹ the Court of Appeals for the First Circuit dealt with the ability of a taxpayer to defer² imposition of federal income tax. The court sanctioned the use of an escrow³ mechanism to defer the realization of gain upon the sale of stock in a closely-held corporation. The rule generally applied by courts and the Internal Revenue Service (“Service”) is that when a buyer irrevocably places sale proceeds in an escrow account to be paid to the seller-taxpayer⁴ at a later time, and no condition other than the passage of time prevents the seller-taxpayer from receiving the funds, the seller-taxpayer is treated as realizing income as of the time when the funds were given to the escrowee⁵ for deposit in the escrow account.⁶

Seller-taxpayers have avoided the realization of gain in the year of sale by use of the installment method of tax accounting.⁷ The installment method permits a seller-taxpayer to recognize only a portion of the gain in each year a payment is made.⁸ However, if *Reed* is followed in other jurisdictions, the escrow arrangement may be used to achieve the same deferral as is obtained using the installment method, with the advantage of securing the sale by placing the proceeds beyond the reach of the buyer.⁹

1. 723 F.2d 138 (1st Cir. 1983).

2. Deferral is usually a tax benefit because the tax on a particular transaction is postponed until the taxpayer files a tax return in a succeeding year. Because of the time value of money, for larger transactions this deferral can result in significant tax savings. However, in *Reed* the deferral amounted to only one week which may have been one unstated reason for the court's ruling in favor of the seller-taxpayer.

3. An escrow is defined as:

any written instrument which by its terms imposes a legal obligation, and which is deposited by the grantor, promisor or obligor, or his agent, with a stranger or third party, to be kept by the depository until the performance of a condition or the happening of a certain event and then to be delivered over to the grantee, promisee or obligee.

Johnson v. Wallden, 342 Ill. 201, 206, 173 N.E. 790, 792 (1930).

4. It is important for the reader to distinguish between the parties. In this Comment the taxpayer is the property seller and is usually receiving some form of cash. In *Reed*, for example, the taxpayer was selling stock and receiving cash from the escrowee.

5. An escrowee is the intermediary between the promisor and the promisee. J. CRIBBET, *PRINCIPLES OF THE LAW OF PROPERTY* 166 (1962). The escrowee occupies a fiduciary position with respect to the property placed in escrow. *Id.* at n.39.

6. *Reed v. Commissioner*, 45 T.C.M. (CCH) 734 (1982), *rev'd*, 723 F.2d 138 (1st Cir. 1983).

7. I.R.C. § 453 (1982). For a discussion of the fundamentals of the installment method, see *infra* text accompanying notes 148–60. A major problem with forcing the seller-taxpayer to realize a gain in a single year is the possibility that the gain is very large as compared to the actual cash received. Often the seller-taxpayer must pay a huge tax on highly mortgaged property. As a result the cash proceeds actually received are far less than the tax due.

8. *Id.*

9. Of course, once the proceeds are no longer under the control of the buyer, the seller-taxpayer need not rely on the buyer's creditworthiness. Since financing is a major obstacle in most commercial transactions, an arrangement that permits the seller-taxpayer to secure the sale by irrevocably placing the proceeds beyond the buyer's control is of great value.

The underlying issue in analyzing escrow arrangements such as the one in *Reed* is how secure the seller-taxpayer can make the transaction before the seller-taxpayer has enough ownership attributes to justify imposition of federal income tax. Professor Bittker has said, "[i]n short, there is an inverse relationship between financial security and tax security: Taxpayers who want one must give up the other."¹⁰

II. THE CASE OF *Reed v. Commissioner*

A. Facts

The taxpayer, John E. Reed, owned approximately 20 percent of Electromech, a closely held corporation.¹¹ Reed and several other shareholders entered into an agreement giving Joseph Cvengros an option to buy their Electromech stock. Cvengros exercised his purchase option on November 23, 1973.¹² The closing was scheduled for December 27, 1973.¹³

The sellers, and the taxpayer in particular, became concerned about the potentially adverse tax consequences of the sale and tried to postpone the closing until 1974.¹⁴ Reed was interested in a postponement because he wanted to offset the capital gain from the sale of Electromech stock with the sale of other investments that would generate capital losses.¹⁵ Since the sale of the Electromech stock was to take place at the end of 1973, Reed was concerned that he would not have enough time to organize the sale of his other investments to offset the capital gain from the sale of Electromech stock.¹⁶ Reed also was concerned that Cvengros's financing would fail, making it impossible for Reed to offset his capital losses with the sale of Electromech stock.¹⁷ At first, the buyers insisted on a 1973 sale.¹⁸ Eventually, the parties agreed orally to modify the original sale agreement and to defer the proceeds.¹⁹ The oral modification was eventually memorialized in a written escrow agreement.²⁰

At the closing, Cvengros endorsed and delivered a check to the American National Bank and Trust Company as escrowee.²¹ Simultaneously, the taxpayer and the other selling shareholders delivered the stock to Cvengros. The escrow agreement provided that the sellers were not to receive any investment income or any other

10. 4 B. BITTKER *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, 105-30 (1981).

11. *Reed v. Commissioner*, 723 F.2d 138, 140 (1st Cir. 1983).

12. *Id.* at 141.

13. *Id.* at 140.

14. *Id.* at 141.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. Neither the Tax Court nor the Court of Appeals was concerned about the oral modification to the original sale agreement. The Court of Appeals said, "[W]e are unable to say that the deferred payment agreement was any less bona fide or any less a part of the purchase-sale agreement merely because it was not memorialized until just prior to closing." *Id.* at 144. The Tax Court said, "an existing agreement which has been modified to provide for deferred payment of amounts not yet due generally will also be effective to postpone recognition of income." *Reed v. Commissioner*, 45 T.C.M. (CCH) 398, 400 (1982), *rev'd*, 723 F.2d 138 (1st Cir. 1983).

20. *Reed v. Commissioner*, 723 F.2d 138, 140 n.1 (1st Cir. 1983).

21. *Id.* at 141. Cvengros obtained outside financing for the amount of \$808,500.

incidental financial benefits.²² The agreement also provided that the escrowee was to distribute the proceeds to the seller-taxpayer on January 3, 1974.²³ Thus, only a week had to pass before the sellers could receive the escrowed sale proceeds.

In a memorandum decision, the Tax Court held summarily that Reed realized gain from the sale when Cvengros deposited the proceeds in the escrow account.²⁴ Relying mainly on prior Tax Court decisions,²⁵ the court said:

[W]hen, upon receipt of the goods, the buyer deposits the full purchase price in an escrow account to be paid to the seller at a later date and no condition other than the passage of time is placed on the seller's right to receive the escrow funds, courts have held that the seller recognizes income when the buyer deposits the funds with the escrowee.²⁶

The taxpayer appealed, and the First Circuit reversed the Tax Court.²⁷

B. *The Court of Appeals Decision*

The Court of Appeals for the First Circuit held that John Reed did not have to recognize income in 1973, the year of sale.²⁸ The court was concerned only with what the taxpayer received in the transaction. The court concluded that an escrow device could effectively postpone the realization of gain on a deferred payment sale provided that three conditions were met:

- (1) the escrow arrangement is part of a bona fide, arms-length agreement between the purchaser and seller calling for deferred payment;
- (2) the seller receives no present beneficial interest (i.e., investment income) from the purchase funds while they are in escrow; and
- (3) the escrowee is not acting under the exclusive authority of the taxpayer.²⁹

In holding for the taxpayer, the court concluded that these conditions were satisfied.

The Service advanced three main arguments.³⁰ First, it argued that the taxpayer had constructively received the sale proceeds in the prior tax year because the escrow device was self-imposed. Second, the Service contended that the taxpayer had received an economic benefit because the right to receive the proceeds was irrevocably vested at the time the funds were placed in escrow. Finally, the Service argued that even if the escrow was found not to be self-imposed, the escrowee was the taxpayer's agent. The Service then reasoned that receipt by the taxpayer's agent constitutes receipt by the taxpayer. The Service's conclusion under each of the three

22. *Id.*

23. *Id.*

24. *Reed v. Commissioner*, 45 T.C.M. (CCH) 398 (1982), *rev'd*, 723 F.2d 138 (1st Cir. 1983).

25. *See, e.g.*, *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *Stiles v. Commissioner*, 69 T.C. 558, 563 (1978); *Oden v. Commissioner*, 56 T.C. 569, 577 (1971); *Pozzi v. Commissioner*, 49 T.C. 119 (1967); *Kuehner v. Commissioner*, 20 T.C. 875 (1953), *aff'd*, 214 F.2d 437 (1st Cir. 1954).

26. *Reed v. Commissioner*, 45 T.C.M. (CCH) 398, 400 (1982), *rev'd*, 723 F.2d 138 (1st Cir. 1983).

27. *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983).

28. *Id.* at 149.

29. *Id.*

30. *Id.* at 142.

arguments was that the taxpayer realized the gain from the sale of Electromech stock in 1973 when the funds were placed in the escrow account.

The court responded to these arguments consecutively. It summarized the constructive receipt doctrine as "an unqualified, vested right to receive immediate payment."³¹ The doctrine is not part of the Internal Revenue Code ("Code"), but it has been part of the Treasury Regulations since 1919.³² Under the regulations, constructive receipt is income that has been made available to the taxpayer but has not actually been reduced to the taxpayer's possession.³³ The regulations add that there is no constructive receipt when the taxpayer's control "is subject to substantial limitations or restrictions."³⁴

The constructive receipt doctrine is generally applied when a cash basis taxpayer refuses payment in favor of an escrow device after payment already has been tendered.³⁵ In *Reed* the Service argued that full payment was tendered when Cvengros placed the funds in the escrow account.³⁶ The court found, however, that the constructive receipt doctrine is applicable only when the taxpayer creates a self-imposed limitation,³⁷ and held that the escrow account in *Reed* was not self-imposed.³⁸ Moreover, the court stated that an escrow account with time as the only restriction could be considered a substantial limitation on the taxpayer's control of the escrowed funds.³⁹

After finding that the constructive receipt doctrine was inapplicable, the court turned to an analysis of the economic benefit doctrine.⁴⁰ The Service argued that Reed received an economic benefit when the buyer deposited the proceeds in escrow because the seller-taxpayer received a cash equivalent.⁴¹ The Service argued further that the cash equivalent is demonstrated by the taxpayer's ability to assign the right to receive future payment.⁴²

31. *Id.*

32. T.D. 2831, 21 Treas. Dec. Int. Rev. 189 (1919).

33. The full text of Treas. Reg. § 1.451-2(a) (1958) provides as follows:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Treas. Reg. § 1.451-2(a) (1958).

34. *Id.*

35. *See, e.g., Williams v. United States*, 219 F.2d 523 (5th Cir. 1955). The taxpayer entered into a contract for the sale of his timber. Instead of accepting immediate payment the taxpayer arranged an escrow account to attempt to defer the realization of the gain on the timber sale. The Fifth Circuit held for the Service because it was persuaded that the taxpayer had control over the sale proceeds because the escrow arrangement was self-imposed. *Id.* at 527.

36. *Reed v. Commissioner*, 723 F.2d 138, 142 (1st Cir. 1983).

37. *Id.* at 143.

38. *Id.* "Self-imposed" in this context means that the seller-taxpayer controls the escrow arrangement either directly or through the use of the escrowee in an agency capacity.

39. The court cited *Commissioner v. Tyler*, 72 F.2d 950 (3d Cir. 1934), for the proposition that time could be a substantial limitation when there is a bona fide sale agreement between the buyer and seller. *Reed v. Commissioner*, 723 F.2d 138, 142-43 (1st Cir. 1983).

40. *Reed v. Commissioner*, 723 F.2d 138, 145 (1st Cir. 1983).

41. *Id.* Property received is a cash equivalent when it may be readily converted into cash. Thus, a promise to pay is the equivalent of cash when it is marketable. *See infra* text accompanying notes 81-125.

42. *Reed v. Commissioner*, 723 F.2d 138, 145 (1st Cir. 1983).

In making the economic benefit argument, the Service relied on the court's 1954 decision in *Kuehner v. Commissioner*.⁴³ In *Kuehner*, the taxpayer sold her 50 shares of stock in Alkay Jewelry Co. for \$65,000.⁴⁴ The proceeds were to be paid to the taxpayer in equal installments of \$13,000 over a consecutive five-year period.⁴⁵ The escrowee agreed to release 10 shares of stock to the buyer and \$13,000 cash to the seller during the five-year period.⁴⁶ At the end of the five-year period the seller-taxpayer was to receive the accumulated interest income from the entire sale proceeds.⁴⁷ In addition, full voting rights were transferred to the buyer as the shares of stock were transferred.⁴⁸ Thus, the Service argued that the seller-taxpayer had received a present interest with an ascertainable value that was subject to federal income taxation.⁴⁹ In *Kuehner* the Tax Court agreed with the Service, holding that as only formal acts by the trustee prevented the taxpayer from receiving the sale proceeds, the sale was complete when the buyer placed the proceeds in escrow.⁵⁰

The *Reed* court rejected the application of *Kuehner* for three reasons. First, the taxpayer in *Reed* did not receive a present beneficial interest. The court said that in *Kuehner* the taxpayer received interest income which made it distinguishable from *Reed*.⁵¹ Second, the court said that to apply *Kuehner* as the Service urged "would be at odds with the well established principle that a deferred payment arrangement is effective to defer income recognition to a cash basis taxpayer provided it is part of an arms-length agreement" ⁵² Last, the court said that application of the economic benefit doctrine to *Reed* "would significantly erode the distinction between cash and accrual methods of accounting."⁵³

43. 214 F.2d 437 (1st Cir. 1954).

44. *Id.* at 438.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 439.

50. *Kuehner v. Commissioner*, 20 T.C. 875, 884 (1953), *aff'd*, 214 F.2d 437 (1st Cir. 1954).

51. *Reed v. Commissioner*, 723 F.2d 138, 146 (1st Cir. 1983). Receipt of interest income is a strong indication that the seller-taxpayer received an economic benefit because he or she is in the same economic position as if cash had been received directly and deposited in a bank account. In *Kuehner* the parties assumed the benefits and burdens of ownership and the essence of the escrow arrangement was no different than an outright sale. The *Reed* court held that *Kuehner* was distinguishable mainly because the seller-taxpayer in *Reed* did not receive a present beneficial interest such as investment income.

52. *Id.*

53. *Id.* at 147. Traditionally, a distinction has been made between "cash basis" taxpayers, who realize income and expenses only upon actual receipt or payment of cash, and "accrual basis" taxpayers, who realize income as it is earned and expenses as they are incurred. I.R.C. § 446(c) (1982). Goldberg, *Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980*, 34 TAX LAWYER 605, 630 n.84 (1981). Apparently, the rationale for the distinction is overall fairness to the taxpayer. A system that permits the realization of income only upon actual receipt enables a taxpayer to pay the tax due using the cash proceeds that were received. If a cash basis taxpayer is forced to realize income when it is earned, at the point when the proceeds are placed in escrow, then the taxpayer may find that there are insufficient funds to pay the tax. *Id.* at 627 n.78.

Another explanation for the use of the cash method of tax accounting is that the cash method is easily applied and administered. *Id.* at 627. Use of the cash method minimizes or eliminates the need to allocate receipts and expenses and thus reduces bookkeeping costs. Moreover, from the standpoint of compliance with the Code, actual receipt provides an easy benchmark for identification of a taxable event and permits the Service to more easily verify income received by the taxpayer.

When the economic benefit doctrine is applied to a cash basis taxpayer, the court noted, "courts generally go beyond an inquiry into the fair market value of the contract right to ask the separate question of whether the contractual right is the equivalent of cash."⁵⁴ A cash equivalent is defined as the ability to "readily convert the promissory obligation into cash in established markets."⁵⁵ The court viewed the escrow account as a mere security device rather than as present payment.⁵⁶ Therefore, the court found that the seller-taxpayer had received no cash equivalent.

Finally, the *Reed* court rejected the Service's argument that the escrowee was Reed's agent.⁵⁷ In so doing, the court followed the same line of reasoning as it did in its rejection of the constructive receipt doctrine,⁵⁸ stating that the underlying attack is the same in both situations.⁵⁹ To impose federal income tax under either the constructive receipt doctrine or agency theory, the deferral must have been unilaterally imposed and not part of a bona fide agreement. The court was persuaded by the active participation of both parties in the escrow arrangement, and thus found that the escrow was not unilaterally imposed.⁶⁰ Moreover, the buyer initially refused to modify the timing of the sale.

III. ANALYSIS OF *Reed v. Commissioner*

A. *The Constructive Receipt and Economic Benefit Doctrines Compared*

The limitation that the constructive receipt doctrine places on the ability of a cash basis taxpayer to structure a transaction has been explained by the United States Supreme Court thus: "The income that is subject to [taxpayers'] unfettered command and that [they are] free to enjoy at [their] own option may be taxed to [them] as [their] income, whether [they] see fit to enjoy it or not."⁶¹ Other courts have interpreted the doctrine to mean that taxpayers may not "deliberately turn [their] back[s]" on income and report it in the year of their choosing.⁶²

The economic benefit doctrine dictates that a tax be imposed on any benefit conferred so long as the benefit has an ascertainable fair market value.⁶³ In other words, something of value must be transferred and actually received before the

54. *Reed v. Commissioner*, 723 F.2d 138, 147 (1st Cir. 1983).

55. Goldberg, *supra* note 53, at 629. For a discussion of cash equivalency, see *infra* text accompanying notes 81-125.

56. *Reed v. Commissioner*, 723 F.2d 138, 148 (1st Cir. 1983) ("the escrow account was not intended by the parties as present payment of the purchase price, but rather was intended to serve as an added assurance that payment would be made in the next year.").

57. *Id.* at 149. This argument logically follows and is based on the agency principle that "receipt of the proceeds by the seller's agent is tantamount to receipt by the principal." *Id.* at 148. See, e.g., *Maryland Casualty Co. v. United States*, 251 U.S. 342, 347 (1920). Courts have held the taxpayer-principal liable for federal income tax based on this theory. *Hines v. United States*, 90 F.2d 957 (7th Cir.), *cert. denied*, 302 U.S. 756 (1937).

58. *Reed v. Commissioner*, 723 F.2d 138, 148 (1st Cir. 1983).

59. *Id.*

60. *Id.* at 141, 149. The success of the agency argument depends on the effectiveness of the constructive receipt doctrine after the agency relationship is established, therefore, the agency argument is conceptually the same and will not be treated separately in this Comment.

61. *Corliss v. Bowers*, 281 U.S. 376, 378 (1930). See text accompanying notes 28-36.

62. See, e.g., *Hamilton Nat'l Bank v. Commissioner*, 29 B.T.A. 63, 67 (1933).

63. See generally MERTONS, 2 LAW OF FEDERAL INCOME TAXATION, § 10.01 (1982).

economic benefit doctrine is triggered. However, this does not mean that the *property* must actually be received. As the Court of Appeals for the First Circuit noted, the economic benefit doctrine is generally applied only when the taxpayer has received a cash equivalent, because upon receipt of a cash equivalent the taxpayer has received something ascertainable.⁶⁴

The traditional distinction made between the constructive receipt doctrine and the economic benefit doctrine is that "constructive receipt deals with 'when' property should be included in a taxpayer's gross income, . . . while economic benefit deals with 'what' property or rights actually received by a taxpayer should be subject to immediate taxation."⁶⁵ Thus, the constructive receipt doctrine is primarily concerned with timing, while the economic benefit doctrine, although concerned with timing, deals with broader questions of ownership. The thrust of the distinction is that for proper application of the economic benefit doctrine the taxpayer must actually receive something that has an ascertainable value, whereas the constructive receipt doctrine is better applied to situations in which the taxpayer has power over immediate payment of the proceeds.⁶⁶

As the court acknowledged in *Reed*, the constructive receipt and economic benefit doctrines overlap,⁶⁷ and, as a result, any distinction is somewhat artificial. Ultimately, imposition of either doctrine has the same net effect: the entire gain is taxed in the year the transaction occurs. This is true because if the Service is successful, realization is deemed to occur at the point when the property is irrevocably placed into the escrow account.⁶⁸ Consequently, the thrust of the argument is on the timing of the imposition of the federal income tax.⁶⁹ The seller-taxpayer may be faced with a much larger gain than anticipated merely because he or she was forced to include the entire proceeds in gross income for the year of sale. Furthermore, installment treatment may be denied and therefore the federal income tax will be substantially larger because the entire gain is taxed in the year of sale.⁷⁰

As traditionally applied, the constructive receipt doctrine was properly rejected by the Court of Appeals. General constructive receipt theory should not be applied to cases in which bona fide escrow agreements prohibit the seller-taxpayer from

64. The imposition of federal income tax upon the receipt of a cash equivalent may be found in the regulations dating back to 1919. T.D. 2831, 21 Treas. Dec. Int. Rev. 189 (1919). However, the formal genesis of the economic benefit doctrine is found in *Commissioner v. Smith*, 324 U.S. 177 (1945). Note, *Goldsmith v. United States*, 586 F.2d 810 (Ct. Cl. 1978), 33 TAX LAWYER 308, 311 (1979); See also Metzger, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV., 525, 550-51 (1974). Today, the economic benefit doctrine is incorporated in the regulations to Code section 446. Treas. Reg. § 1.446-1(a)(3) (1958). Section 446 of the Code sets forth the general methods of tax accounting.

65. Metzger, *supra* note 64.

66. The two doctrines are merely different ways of answering the same question: Who owns the property?

67. *Reed v. Commissioner*, 723 F.2d 138, 142 (1st Cir. 1983).

68. See Rev. Rul. 60-31, 1960-1 C.B. 174, 180, *modified*, Rev. Rul. 64-279, 1964-2 C.B. 121, *modified further*, Rev. Rul. 70-435, 1970-2 C.B. 100. In this ruling the Service cited *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952), for the proposition that the point of realization is the time at which the amount received by the taxpayer is irrevocably paid out for the taxpayer's benefit. See also Private Letter Ruling 8113107 ¶ 54,952 (P.H.) (1980) (citing *Sproull* for the same proposition.).

69. The timing of the tax is critical because acceleration of the taxable event to the year of sale can have devastating effects on the cash flow of the seller-taxpayer.

70. See *infra* text accompanying notes 160-64.

reducing the property to physical possession.⁷¹ The taxpayer is unable to exercise control over the funds unless the escrow is a subterfuge and the escrowee is the taxpayer's agent.⁷²

The Service argued that *Williams v. United States*⁷³ applied because the escrow was self-imposed by the taxpayer.⁷⁴ In *Williams* the taxpayer entered into a contract for the sale of his timber. The taxpayer declined to accept immediate payment, instead arranging an escrow account in an attempt to defer the realization of the gain on the sale.⁷⁵ The Court of Appeals for the Fifth Circuit held for the Service because it was persuaded that the taxpayer had control over the sale proceeds. The buyer was ready, willing, and able to deliver the purchase price.⁷⁶ This is a classic application of the constructive receipt doctrine.

The Court of Appeals for the First Circuit correctly rejected the application to *Reed* of the reasoning in *Williams*.⁷⁷ In *Williams* the sale had taken place and the taxpayer was in constructive receipt before the escrow account was established.⁷⁸ The correct focus of the constructive receipt doctrine is *when* the escrow was imposed, rather than the nature of its imposition.⁷⁹ In *Williams*, unlike *Reed*, the escrow was imposed after the taxpayer was in constructive receipt.⁸⁰ Consequently, the taxpayer in *Williams* did constructively receive the escrow proceeds, but the taxpayer in *Reed* did not. Although the distinction between the economic benefit and constructive receipt doctrines is somewhat artificial, the economic benefit doctrine is more applicable to the facts of *Reed*.

B. When Has a Seller Received an Economic Benefit?

The formal basis of the economic benefit doctrine may be found in the evolution of the cash equivalent doctrine.⁸¹ The First Circuit properly applied the cash

71. *Goldsmith v. United States*, 586 F.2d 810, 817-20 (Ct. Cl. 1978).

72. If the seller-taxpayer is able to direct the investment of the escrow proceeds, and if the gross amount is payable to the seller-taxpayer as in *Kuehner v. Commissioner*, 214 F.2d 437, 438 (1st Cir. 1954), it would be more difficult to dispute application of the constructive receipt doctrine. The seller-taxpayer will have done everything consistent with ownership, and the artificial delay imposed by the escrow account should be insufficient to defer the imposition of federal income tax, even though a technical reading of regulation § 1.451-2(a) would indicate that the proceeds would not be constructively received. See *supra* notes 28-32 and accompanying text. Under the circumstances described above both the economic benefit and constructive receipt doctrines should be applicable.

73. 219 F.2d 523 (5th Cir. 1955).

74. See *supra* text accompanying notes 37-39.

75. *Williams v. United States*, 219 F.2d 523, 524 n.2 (5th Cir. 1955).

76. *Id.*

77. *Reed v. Commissioner*, 723 F.2d 138, 144 (1st Cir. 1983).

78. *Williams v. United States*, 219 F.2d 523, 527 (5th Cir. 1955); see also Falk, *Constructive Receipt and Economic Benefit: Putting Reed in the Proper Perspective*, 62 TAXES 425 (1984):

[T]he court rightfully distinguished the *Williams* decision from the facts in *Reed*, because the taxpayer was in constructive receipt at the time of the attempted deferral in *Williams*, while *Reed* was never in constructive receipt at the time of the contract modification. This is a crucial distinction since receipt—actual or constructive—is the point of taxation for a cash basis taxpayer, and, after the right to receive ripens to receipt, no arrangement can alter the taxability.

Id. at 428.

79. Falk, *supra* note 78.

80. *Williams v. United States*, 219 F.2d 523, 524 n.2 (5th Cir. 1955).

81. See *supra* note 64.

equivalent doctrine to the escrow arrangement in *Reed*.⁸² Property received that does not consist of cash is nevertheless the equivalent of cash when it may be readily converted into cash.

It seems that it is impossible to say exactly what interests constitute an economic benefit, especially when the taxpayer has received noncash property.⁸³ But it is manifestly true that at some point a noncash benefit becomes so ascertainable and fixed in time and amount and so much like cash that the economic benefit doctrine must be invoked to preserve the integrity of the tax system. If this were not true, taxation could be avoided by simply providing for payment with a cash equivalent. However, the underlying question is at what point the property received is so equivalent to cash as to justify treating the property as part of the amount realized under section 1001 of the Code.⁸⁴

1. *Classification of a Promise to Pay as a Cash Equivalent*

At common law, three general rules have been identified by the courts when construing a payment that is potentially the equivalent of cash.⁸⁵ First, the receipt of a mere promise to make a deferred payment will not result in immediate realization of income if the promise is not evidenced by a note or otherwise secured by an indebtedness that might be readily marketable.⁸⁶ Second, the receipt of a promise, whether or not secured by a note or otherwise, will not result in immediate realization of income if the promise is intended by the parties as mere evidence of payment rather than payment itself.⁸⁷ Finally, an unconditional promise to make a deferred payment, evidenced by a note or secured otherwise, will trigger federal income tax if the promise is intended as payment and if it has an ascertainable fair market value.⁸⁸

In situations involving escrow accounts, the Tax Court's position has been articulated on several occasions in the installment sale area,⁸⁹ and its position generally supports the rules set out above.⁹⁰ The Tax Court has held that when the funds set aside in the escrow account are intended merely to secure payment, a cash basis taxpayer does not realize income until actual receipt of the proceeds.⁹¹ However, if the seller receives payment directly from the escrow account, the constructive

82. See *infra* text accompanying notes 106-12.

83. The property *Reed* received was the escrow agreement which served as evidence of the indebtedness owed by the buyer. In *Reed* receipt of the proceeds in the escrow account was inevitable. *Reed v. Commissioner*, 723 F.2d 138, 141 (1st Cir. 1983).

84. From a technical standpoint, finding a cash equivalent is important because that is part of the amount realized. I.R.C. § 1001(b) (1982). The amount realized is the starting point in computing the taxpayer's gain on the property disposition. I.R.C. § 1001(a) (1982). Once it is concluded that something of value has been transferred and that it is the equivalent of cash, it must be included in the amount realized to the extent of its fair market value. I.R.C. § 1001(b) (1982).

85. Metzger, *supra* note 64, at 553-55.

86. *Id.* at 553-54.

87. *Id.* at 554.

88. *Id.* at 554-55.

89. See *infra*, notes 148-53 and accompanying text for a discussion of the installment method of reporting.

90. See *infra* notes 91-93.

91. See, e.g., *Porterfield v. Commissioner*, 73 T.C. 91, 95 (1979).

receipt doctrine⁹² and the economic benefit doctrine⁹³ are invoked to trigger realization of income relating back to the time the buyer placed the funds in escrow. Apparently, the Tax Court reasons that, if the funds are set aside as payment of an underlying debt, then the escrow account represents more than a mere promise to pay.⁹⁴ Instead, it represents an economic benefit that has an ascertainable market value.

Historically, the Service's position on the effectiveness of an escrow device to defer realization of income has been unclear for several reasons. First, the Service's position is unclear because it has changed its viewpoint. In Revenue Ruling 68-246, the Service took the position that time alone would suffice as a substantial limitation on the taxpayer's control.⁹⁵ The Service thereby sanctioned the use of an escrow device as a valid mechanism to defer federal income tax. However, in 1977 the Service revoked Revenue Ruling 68-246, and since then has consistently rejected the use of an escrow device to defer taxation when the escrow proceeds are used directly as part of the consideration received by the seller-taxpayer.⁹⁶ Second, the Service's position has remained unclear because it has never fully articulated its reason for rejecting the escrow device. More specifically, the Service has not limited its attack to either the constructive receipt or economic benefit doctrine. Rather, it has used a blanket prohibition where the seller-taxpayer receives any part of the consideration from the escrow account.⁹⁷

In Revenue Ruling 77-294,⁹⁸ the Service revoked Revenue Ruling 68-246 and ruled that an escrow does not create a substantial limitation or restriction by an

92. See, e.g., *Arnwine v. Commissioner*, 696 F.2d 1102 (5th Cir. 1983); *Warren v. United States*, 613 F.2d 591 (5th Cir. 1980); *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *Kuehner v. Commissioner*, 214 F.2d 437 (1st Cir. 1954).

93. See, e.g., *Griffith v. Commissioner*, 73 T.C. 933 (1980); *Oden v. Commissioner*, 56 T.C. 569 (1971); *Pozzi v. Commissioner*, 49 T.C. 119 (1967).

94. *Porterfield v. Commissioner*, 73 T.C. 91, 93 (1979). In construing the intention of the parties, the Tax Court ignored clear contractual language that permitted the seller-taxpayer to receive the escrow proceeds directly.

95. 1968-1 C.B. 198. In this ruling, the taxpayer received, in the year of sale, 30% as a down payment and an installment note for the remainder of the selling price. *Id.* at 199. The parties subsequently established an escrow account as a receptacle for the remainder of the sale proceeds. *Id.* The buyer transferred the proceeds to the escrowee in consideration for cancellation of the lien on the property transferred. Thus, an escrow account was substituted for the previously arranged installment note. The escrowee released the subsequent installments, but the buyer was personally liable for any unpaid installment payments. *Id.*

The Service took the position that the escrow arrangement prevented the taxpayer from receiving the funds and therefore payment could not be accelerated. *Id.* In effect, the substitution of the escrow fund after the sale was considered part of the sale proceeds because nothing had changed: the taxpayer was no closer to the funds than before the escrow substitution. *Id.* Consequently, installment treatment was permitted. *Id.*

In several cases with similar fact patterns, installment treatment has been denied. See, e.g., *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *Griffith v. Commissioner*, 73 T.C. 933 (1980); *Oden v. Commissioner*, 56 T.C. 569 (1971); *Pozzi v. Commissioner*, 49 T.C. 119 (1967).

96. Rev. Rul. 77-294, 1977-2 C.B. 173, *amplified*, Rev. Rul. 79-91, 1979-1 C.B. 179. The seminal ruling on deferral is 60-31, in which the Service discussed five examples of deferral including a case in which the Service rejected the use of an escrow device to defer imposition of federal income tax. 1960-1 C.B. 174, *modified*, Rev. Rul. 64-279, 1964-2 C.B. 121, *modified further*, Rev. Rul. 70-435, 1970-2 C.B. 100. In addition, regulation § 1.61-2(d)(4) long has provided that receipt of a note in payment for services is compensation to the extent of its fair market value. Treas. Reg. § 1.61-2(d)(4) (1958). The Service continues to reject the use of an escrow device in the installment sale area. Temp. Treas. Reg. § 15a.453-1(b)(5)(ex 8), T.D. 7768, 1981-1 C.B. 296, 301.

97. Temp. Treas. Reg. § 15a.453-1(b)(5)(ex 8), T.D. 7768, 1981-1 C.B. 296, 301.

98. Rev. Rul. 77-294, 1977-2 C.B. 173, *amplified*, Rev. Rul. 79-91, 1979-1 C.B. 179.

installment seller.⁹⁹ Therefore, installment treatment was denied and the seller-taxpayer was forced to include the entire proceeds in gross income in the year of sale.¹⁰⁰ Since the Service did not articulate its reasoning it is unclear which doctrine was applied.

The result is the same under either the Service's or the Tax Court's position: an escrow account may not be used to defer taxation unless the taxpayer carefully structures the transaction to appear as mere security.¹⁰¹ This requires that the escrow proceeds not be used as part of the consideration paid to the seller-taxpayer.

2. The Cash Equivalent Doctrine as it Applies to *Reed v. Commissioner*

In examining what the taxpayer in *Reed* received, the court initially focused on whether the taxpayer received a present beneficial interest—interest income. *Reed* received no obvious present beneficial interest from the escrowee. The court, however, also asked whether the taxpayer received anything that could constitute a cash equivalent.¹⁰² Essentially, the court examined the economic reality of the transaction and asked whether *Reed* was in a better economic position than if he had received an unsecured promise.¹⁰³ “The proper test should look to the character of the receipt because the touchstone is whether the taxpayer is in an economic position essentially equivalent to having received cash. . . . [S]ubjective intent . . . [is] irrelevant to this inquiry.”¹⁰⁴ The analysis of the taxpayer's economic position is not enhanced by determining the intention of the parties, as the Tax Court and the Service routinely maintain. Therefore, a cash basis seller should not include the buyer's future promise of payment in the current taxable year unless the promise is the equivalent of cash,¹⁰⁵ regardless of the intent of the parties.

One basis for its refusal to apply *Kuehner v. Commissioner*¹⁰⁶ was the Court of Appeal's finding that, when applying the economic benefit doctrine to a cash basis taxpayer, an inquiry should be made into whether the taxpayer received a cash equivalent.¹⁰⁷ The court added that “[w]ithout this separate inquiry, the economic benefit doctrine, as applied to a cash basis taxpayer, could be broadly construed to cover all deferred compensation and deferred payment contracts.”¹⁰⁸

99. *Id.*

100. Rev. Rul. 77-294, 1977-2 C.B. 173, 1974, *amplified*, Rev. Rul. 79-91, 1979-1 C.B. 179.

101. For some planning suggestions, see generally Braubach & Wishaar, *Securing Installment Sales With Letters of Credit and Escrow Arrangements*, 9 J. REAL EST. TAX. 203 (1982); Klein, *Installment Sale Success Story—Escrow Funds Are Security, Not Payment in the Year of Sale*, 7 J. REAL EST. TAX. 280 (1980); Ledlie, *Letters of Credit or Escrow Accounts Used as Security in Installment Sale Transactions*, 60 TAXES 130 (1982); Maples, *Recent decisions make it easier to use escrow accounts to defer the recognition of income*, 33 TAX'N FOR ACCT 20 (1984); Parker, *Substitution of escrow will destroy benefits of installment sale says IRS*, 47 J. TAX'N. 346 (1977).

102. *Reed v. Commissioner*, 723 F.2d 138, 147 (1st Cir. 1983).

103. See generally MERTONS, *supra* note 63.

104. Goldberg, *supra* note 53, at 630 n.84.

105. *Warren Jones Co. v. Commissioner*, 60 T.C. 663, 667 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975); *Estate of Hurlburt v. Commissioner*, 25 T.C. 1286, 1288-89 (1956); *Estate of Ennis v. Commissioner*, 23 T.C. 799, 802 (1955); *Ennis v. Commissioner*, 17 T.C. 465, 469 (1951); *Johnston v. Commissioner*, 14 T.C. 560, 566 (1950).

106. 214 F.2d 437 (1st Cir. 1954). For a review of the facts of *Kuehner*, see *supra* text accompanying notes 43-48.

107. *Reed v. Commissioner*, 738 F.2d 138, 147 (1st Cir. 1983).

108. *Id.*

Some commentators have criticized the use of the cash equivalent approach in analyzing whether the taxpayer has received an economic benefit.¹⁰⁹ In *Warren Jones Co. v. Commissioner*,¹¹⁰ the Court of Appeals for the Ninth Circuit reversed the Tax Court and held that the amount realized by the taxpayer must include the fair market value of property received, if ascertainable.¹¹¹ Essentially, the *Warren Jones* court rejected the use of marketability as a measure of realization. Instead, the court's test stated that if the property received has an ascertainable fair market value it must be included as a part of the amount realized under section 1001(b) of the Code.¹¹²

Marketability should be distinguished from the concept of ascertainable fair market value.¹¹³ "[I]t is absurd to speak of a promise to pay a sum in the future as having a 'market value,' fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and higgling with him [or her] on the basis of the particular transaction."¹¹⁴ Of course, if no market for the indebtedness exists, then the ascertainable fair market value is zero. If that were the case, in effect there would be no difference between marketability and ascertainable fair market value, and the result would be the same under either theory.

Whether an asset is "readily marketable," and if so, at what point in time it becomes marketable, are questions subject to interpretation. In *Cowden v. Commissioner*¹¹⁵ the court listed several indicia of a readily marketable asset.¹¹⁶ The taxpayer in that case had leased mineral rights to Stanolind in return for royalty payments which would become due in January of each year.¹¹⁷ The contract amount was an absolute personal obligation of the oil company.¹¹⁸ Thereafter, the taxpayer assigned the rights to the future payments to the First National Bank of Midland, of which the

109. Falk, *Constructive Receipt and Economic Benefit: Putting Reed In Proper Perspective*, 62 TAXES 425, 429 (1984); Haley, *The Application of Section 1001 to Deferred Payment Sales of Property*, 28 TAX LAWYER 303 (1975); Levin & Javaras, *Receipt of Notes and Other Rights to Future Payments by a Cash-Basis Taxpayer*, 54 A.B.A. J. 405, 406 (1968); Llewellyn, *Promises To Pay In The Future—A Modest Proposal For Reform*, 31 U. MIAMI L. REV. 1337, 1340 (1977).

110. 524 F.2d 788 (9th Cir. 1975).

111. The court traced the development of § 1001 of the Code and concluded that the "amount realized" from the sale of "property" no longer depended upon an analysis of marketability and thus no longer depended upon the cash equivalent theory. *Id.* at 792-93. The court deduced this from its analysis of the legislative history of § 1001 and its finding that the words "readily realizable" were deleted from the definition of "amount realized" in the 1924 amendment to § 1001. *Id.*

However, no other courts have adopted this portion of the *Warren Jones* analysis, and commentators have questioned its reasoning. See Goldberg, *supra* note 53, at 635; Weitzman, *Revenue Ruling 69-74: An Administrative Reversal of Burnet v. Logan and The Cash Equivalence Doctrine*, 31 U. FLA. L. REV. 216, 232-40 (1978). See also Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX. L. REV. 471, 556-57 (1975). A better explanation for the removal of the phrase "readily realizable" is the concern that the drafters had for the determination of the value of the amount realized rather than the quite different issue of marketability. Goldberg, *supra* note 53, at 636.

112. *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 792 (9th Cir. 1975).

113. *Reed v. Commissioner*, 723 F.2d 138, 147 n.7 (1983).

114. *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929); see also *Humphrey v. Commissioner*, 32 B.T.A. 280 (1935).

115. 289 F.2d 20 (5th Cir. 1961).

116. *Id.* at 24.

117. *Id.* at 21.

118. *Id.* at 22.

taxpayer was a director.¹¹⁹ The Tax Court was convinced that the payments were not only readily marketable but immediately convertible into cash.¹²⁰

The Court of Appeals for the Fifth Circuit was persuaded that the solvency of the debtor, Stanolind, made collection of the future royalty a certainty.¹²¹ Therefore, in gauging marketability of future payments, the financial capacity of the debtor is a major factor. Second, the contract price was unconditional and the payments assignable.¹²² Third, if the obligation is readily traded in commerce it is unquestionably marketable.¹²³ Finally, if the obligation is transferred at a discount not substantially different from the market value for money at the time, then the obligation is readily marketable and should be treated as a cash equivalent.¹²⁴

If the facts in *Reed* are analyzed under the *Cowden* factors, it appears that the value received by Reed is not distinguishable from that received by the Cowdens. In *Reed*, solvency was not at issue because the buyer did not control the proceeds. Instead, the buyer irrevocably placed the proceeds in the escrow account, and Reed was able to transfer the right to the future payment. No evidence was shown to indicate whether the right could be traded commercially; nevertheless, nothing in the escrow account prohibited an assignment. Finally, the amount placed in escrow represented the full purchase price of the Electromech stock, and no discount rate was applied because deferral amounted to only one week. Thus, under the *Cowden* analysis, the funds in the escrow account in *Reed* were readily marketable and the seller-taxpayer technically received a cash equivalent.

Therefore, the seller-taxpayer in *Reed* received a benefit that could be measured in terms of its marketability. As a result, the court should have applied the economic benefit doctrine to *Reed*. How instead it concluded that the escrow account was intended as merely an added assurance that payment would be made is unclear.¹²⁵ Without the added feature of a forfeiture clause, payment virtually was guaranteed.

3. Assignability as Evidence of an Economic Benefit

The court in *Reed* held that the taxpayer did not receive a present economic benefit¹²⁶ and that the escrow arrangement was bona fide.¹²⁷ However, the Service argued that the ability to assign the right to future payment was an illustration of the taxpayer's economic benefit.¹²⁸

119. *Id.*

120. *Cowden v. Commissioner*, 32 T.C. 853, 858 (1959), *rev'd*, 289 F.2d 20 (5th Cir. 1961) (The Court of Appeals sent the case back to the Tax Court for further findings of fact because it believed that the Tax Court overemphasized the unwillingness of the taxpayers to accept the funds that the lessee was ready, willing, and able to pay. *Cowden v. Commissioner*, 289 F.2d 20, 25 (5th Cir. 1961)).

121. *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961).

122. *Id.*

123. *Id.*

124. *Id.*

125. *Reed v. Commissioner*, 723 F.2d 138, 148 (1st Cir. 1983).

126. *Id.* at 146.

127. *Id.* at 143.

128. *Id.* at 148.

In response to this argument, the court stated that all deferred payment sales could be subject to the assignability argument.¹²⁹ At first, this statement does not appear to be vulnerable to attack. Many deferred compensation plans, installment sales, insurance and annuity contracts, and other arrangements represent valuable present interests in rights to future payments. These are commonly assigned for their discounted value. Only through "legislative grace" are most of these interests exempt from taxation.¹³⁰ Tax liability is usually imposed unless there is an express exclusion from gross income, regardless of the benefit's transferability.¹³¹ Consequently, it seems that the court's argument does little to refute the Service's position.

The court also responded to the Service's assignability argument by saying that while the ability to assign was present the taxpayer did not actually assign the right.¹³² Viewing the transaction as a matter of equity, the court's argument is clearly accurate. However, federal income tax is triggered upon the occurrence of a taxable event. Because of this general policy, it makes little difference that the taxpayer did not actually assign his right. To determine the point of realization, the question of whether the taxpayer exercised the right is not always reached. Once the question whether the taxpayer has received something of value has been answered in the affirmative, the tax will apply at that moment in time.

Including a provision that makes the escrow arrangement nonassignable increases the likelihood of defeating the imposition of the economic benefit theory, since at the very least the argument that the escrow proceeds are the equivalent of cash would be less tenable. Whether it is enough to avoid immediate tax liability has been called "problematical."¹³³ A threshold issue is whether a restriction on alienation would be upheld by a court.

At common law, clauses that restrict alienation, or nonassignment clauses, are valid in most cases.¹³⁴ However, the trend in commercial law is to reject such restrictions as a matter of public policy.¹³⁵ The Uniform Commercial Code (U.C.C.) states: "[A]s accounts and other rights under contracts have become the collateral which secures an ever increasing number of financing transactions, it has been necessary to reshape the law so that these intangibles . . . can be freely assigned."¹³⁶ Section 9-318(4) states:

A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor's consent to such assignment or security interest.¹³⁷

129. *Id.*

130. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.").

131. *BITTNER*, *supra* note 10, at 105-32.

132. *Reed v. Commissioner*, 723 F.2d 138, 148 (1st Cir. 1983).

133. *Gemmill, The "Economic Benefit" Attack on Nonqualified Plans; Cautions for Draftsmen*, 22 J. TAX'N 79, 82 (1965).

134. *Annot.*, 37 A.L.R.2d 1251, 1253-56 (1954).

135. U.C.C. § 9-318 comment 4 (1978).

136. *Id.*

137. U.C.C. § 9-318(4) (1978).

However, an escrow account like the one used in *Reed* may not be within section 9-318(4) of the U.C.C.¹³⁸ An escrow agreement is clear evidence of an underlying contract of sale. Nevertheless, an "account" as used in section 9-318(4) is defined as "any right to payment for *goods sold or leased* or for services rendered"¹³⁹ A "general intangible" is defined as "any personal property . . . other than goods, accounts, chattel paper, documents, instruments, and money."¹⁴⁰ The cash held in escrow in *Reed* fits neither of these definitions. Specifically, the cash is not an "account" because money is expressly excluded from the definition of "goods" in section 9-105 of the U.C.C.¹⁴¹ Likewise, cash is not a general intangible because "money" is expressly excluded by section 9-106.¹⁴²

It may be concluded that Article Nine of the U.C.C. is not directly applicable to a sale of a business or a sale of securities.¹⁴³ Therefore, the restriction on nonassignment clauses found in section 9-318(4) is inapplicable to a *Reed*-type transaction.¹⁴⁴ Nevertheless, the trend in the law is to reject such clauses, and the U.C.C. may be applied by analogy as very persuasive authority.¹⁴⁵ Indeed, the Tax Court has said that transfer restrictions which are "fleeting" will not alter the tax treatment, especially where there is no business purpose for the restriction.¹⁴⁶

After the threshold issue whether a court would uphold a nonassignability clause is resolved, some conclusions may be made. If a court were to uphold the restriction on alienation despite the application of the U.C.C. by analogy, then the Service's argument that the seller-taxpayer's ability to assign the escrow proceeds evidences the present beneficial interest would be more difficult to maintain. Certainly, finding a cash equivalent would be less likely. This Comment has concluded that property received that is not the equivalent of cash may not qualify as an economic benefit.¹⁴⁷ Therefore, deferral using an escrow account could succeed. If the restriction on alienation is not upheld, then inclusion of the nonassignment clause will have little effect on the final determination whether the taxpayer received an economic benefit.

138. *Id.* Moreover, Article Nine may not be applicable. U.C.C. § 9-104 (1978) exempts certain transactions from Article Nine. Subsection (f) exempts the sale of accounts or chattel paper in the context of a sale of the entire business. See, e.g., *Paul v. Chromalytics Corp.*, 343 A.2d 622 (Del. Super. Ct. 1975).

139. U.C.C. § 9-106 (1978) (emphasis added).

140. *Id.*

141. The term "goods" is defined in § 9-105(h) to include all movable things except "money, documents, instruments, accounts, chattel paper, general intangibles, or minerals"

142. Note that in *Reed* the underlying property sold, stock in John Reed's company, is a "security" under § 8-102, which is within the definition of "instrument" in § 9-105. General intangibles expressly exempt "instruments" in § 9-106. Therefore, a security does not qualify as a general intangible for § 9-318(4) purposes. Likewise, a security does not qualify as an account under § 9-106 because "instruments" are expressly excluded from the definition of accounts in § 9-106.

143. See Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX. L. REV. 471, 566 (1975).

144. However, the restriction on nonassignability clauses in § 9-318(4) does apply to a sale of tangible personal property. U.C.C. § 9-318(4) (1978). Application of § 9-318(4) is apparently dependent upon the type of property held in escrow.

145. U.C.C. § 9-318 comment 4 (1978).

146. *Griffith v. Commissioner*, 73 T.C. 933, 941 (1980).

147. See *supra* text accompanying notes 81-83.

IV. FUNDAMENTALS AND POLICIES OF SECTION 453

If a transaction qualifies as an installment sale,¹⁴⁸ a taxpayer may defer realization of gain on a sale by using the installment method of reporting under section 453 of the Code.¹⁴⁹ The function of the installment method is to spread the gain ratably over all taxable years in which the seller-taxpayer receives payments.¹⁵⁰ This alleviates the bunching of the gain which could otherwise occur.¹⁵¹

The general policy behind installment sale treatment is that the burden of appreciation should not be borne by the taxpayer in a single tax year.¹⁵² Since the appreciation in the value of the property sold occurs over a number of years, it is inequitable to force inclusion of the entire gain in one year.¹⁵³

In 1980 section 453 was revised,¹⁵⁴ making the installment method mandatory for all installment sales¹⁵⁵ unless the taxpayer elects not to have section 453 apply.¹⁵⁶ Congress also amended the two-payment rule because it felt that the rule resulted in inequitable application.¹⁵⁷ For example, under pre-1980 law, if a taxpayer sold property in year 19X1 for \$100,000 and received \$1,000 as a down payment with the balance due in one payment in 19X5 the two payment rule was satisfied.¹⁵⁸ Therefore, under pre-1980 law the taxpayer could take advantage of the installment sale method. Conversely, if a taxpayer did not receive a nominal down payment, but instead received the entire sale price in one lump sum in 19X5, the two-payment rule prohibited use of the installment method because the sale consisted of only one payment. Congress felt that this disparate treatment was unjustified.¹⁵⁹ Consequently, it changed the rule so that the installment method could be used if a single payment were received in a year other than the year of sale.¹⁶⁰

If the Service successfully invokes the constructive receipt doctrine or the economic benefit doctrine, then "payment" is deemed to be made in the year of sale. As a result, the taxpayer would not have a deferred sale that qualifies for the installment method. Not only does the taxpayer lose the deferral, but the taxpayer also loses the ability to use the installment method. The result under the two-payment rule would be the same.

148. An "installment sale" is defined as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." I.R.C. § 453(b)(1) (1982).

149. The "installment method" is a method of tax accounting under which the taxpayer recognizes income only for the proportion received in that year which the gross profit bears to the total contract price. I.R.C. § 453(c) (1982).

150. S. REP. NO. 1000, 96th Cong., 2d Sess. 7, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4696, 4701.

151. *Id.*

152. *Id.*

153. However, mitigating provisions already exist in the Code, and this factor militates against an expansive reading of § 453. For example, only 40% of net long-term capital gains are taxed. I.R.C. § 1202(a) (1982). Section 1301 provides for income averaging. I.R.C. § 1301 (1982). This provision permits the spreading out of earnings. Consequently, the Code provides for relief from the bunching problem in other ways.

154. Installment Sales Revision Act, Pub. L. No. 96-471, 94 Stat. 2247 (1980).

155. I.R.C. § 453(a) (1982).

156. I.R.C. § 453(d)(1) (1982).

157. S. REP. NO. 1000, 96th Cong., 2d Sess. 10, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4696, 4704.

158. *Id.*

159. *Id.*

160. I.R.C. § 453(a), (b)(1) (1982).

It seems that the amendments made in 1980 were intended by Congress to liberalize the installment method and encourage taxpayers to use this statutory method of deferral. One of the primary definitional changes made section 453 applicable unless the taxpayer elects out.¹⁶¹ In addition, "payment" is defined as that which "does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person)."¹⁶² The Service treats escrow devices as full payment rather than mere evidence of indebtedness, even though it is unclear that this was the result intended by Congress.¹⁶³ Consequently, the seller-taxpayer must realize the entire sale proceeds in the year of sale. Since no payments are made in a year other than the year of sale the taxpayer is prohibited from using the installment method.

It is unclear whether Congress deliberately has attempted to force taxpayers to use the installment method rather than other methods, such as escrow devices, to defer realization.¹⁶⁴ However, it seems very clear that the 1980 amendments to section 453 were intended to make section 453 more available and more equitable. Perhaps it would be better if section 453 were the exclusive means of deferral of *Reed*-type transactions. Congress has not been so specific.¹⁶⁵

V. CONCLUSION

From the seller's standpoint one of the major problems in arranging a commercial transaction is to reduce the risk that the buyer will default. One purpose of the *Reed* escrow device was to remove the risk of default by placing the funds into an escrow account. Unfortunately, if the seller-taxpayer receives the cash in a lump sum, there may be devastating tax implications.¹⁶⁶ Consequently, an incentive exists to attempt to defer realization of the gain for federal income tax purposes while

161. I.R.C. § 453(a) (1982).

162. I.R.C. § 453(f)(3) (1982).

163. Temp. Reg. § 15a.453-1(b)(5)(ex 8), T.D. 7768, 1981-1 C.B. 296, 301. See Ledlie, *supra* note 101, at 140-42. (Ledlie argues that the use of letters of credit by Congress in S. REP. NO. 1000, 96th Cong., 2d Sess. 18, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 4696, 4713, was intended to be an illustration of a "third-party guarantee" rather than an exclusive list. Ledlie, *supra* note 101, at 140. The Service has, nevertheless, narrowly interpreted the definition of "payment" to include escrow accounts and not letters of credit. Temp. Treas. Reg. § 15a.453-1(b)(5)(ex 8), T.D. 7768, 1981-1 C.B. 296, 301. Ledlie suggests that a letter of credit is a functional equivalent of an escrow account and should not be treated differently. Ledlie, *supra* note 101, at 141-42.)

164. The Ninth Circuit has said that the installment method is "Congress's [sic] method of providing relief from the rigors of [including the entire proceeds in the amount realized in] section 1001(b)." *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 792 (9th Cir. 1975).

165. However, Congress has said:

The creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted. By providing an expanded statutory installment reporting option, the Committee believes that in the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting.

S. REP. NO. 1000, 96th Cong., 2d Sess. 24, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 4696, 4719.

166. If a seller-taxpayer receives a large amount of cash a large portion of that will be used to pay federal income tax. This is because the tax rates are graduated. I.R.C. § 1 (1982). The more cash received the higher the marginal tax rate.

simultaneously removing the risk of default. *Reed v. Commissioner*¹⁶⁷ provides the mechanism for achieving this result.

Taxpayers in the First Circuit are encouraged to follow *Reed*. However, since the taxpayer in *Reed* received an economic benefit, the case is of dubious authority in other jurisdictions.¹⁶⁸ Once the seller-taxpayer has secured the transaction by putting the sale proceeds beyond the buyer's control, then, absent a forfeiture clause, the risk of default has been entirely removed. The essence of the transaction is the same as if an outright sale had occurred.¹⁶⁹ The parties have assumed the benefits and burdens of ownership in substance if not in form. This is true regardless of the intent of the parties.¹⁷⁰

By revising section 453,¹⁷¹ Congress has indicated an intent to encourage the use of the installment method of reporting. Whether Congress specifically meant to discourage the use of the escrow device is uncertain. The Service has taken the position that escrow devices may not be used in the context of an installment sale.¹⁷² However, until Congress expressly precludes the use of escrow arrangements to defer realization of income, such devices probably will be used again.

Gary Friedhoff

167. 723 F.2d 138 (1st Cir. 1983).

168. See *supra* text accompanying notes 102-25.

169. The *Reed* decision makes it easier for unscrupulous taxpayers to evade federal income tax by setting up an escrow arrangement that is actually a subterfuge. The seller-taxpayer could be compensated for the loss of interest income by a commensurate increase in the sale price.

170. See *supra* text accompanying notes 102-05.

171. Installment Sale Revision Act, Pub. L. No. 96-471, 94 Stat. 2247 (1980).

172. Temp. Treas. Reg. § 15a.453-1(b)(5)(ex 8), T.D. 7768, 1981-1 C.B. 296, 301.